IN THE SUPREME COURT OF THE STATE OF MISSOURI

STATE EX REL. OFFICE OF THE PUBLIC COUNSEL,	)	
APPELLANT,	)	
vs.	)	**Case No. SC92964**
MISSOURI PUBLIC SERVICE COMMISSION,	)	
RESPONDENT.	)	

Appeal from the
Missouri Public Service Commission

INITIAL SUBSTITUTE BRIEF OF APPELLANT OFFICE OF THE PUBLIC COUNSEL

Marc Poston (# 45722)
Deputy Counsel
Office of the Public Counsel
P. O. Box 2230
Jefferson City, MO 65102
(573) 751-5558 (Telephone)
(573) 751-5562 (Fax)
marc.poston@ded.mo.gov
Attorney for Appellant

March 8, 2013

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes:

Other Authorities:

JURISDICTIONAL STATEMENT

The Office of the Public Counsel ("OPC" or "Public Counsel") is a state agency that represents utility ratepayers. OPC challenges the lawfulness and reasonableness of a Report and Order of the Missouri Public Service Commission ("Commission" or "PSC") that approved natural gas rates for Atmos Energy Corporation ("Atmos" or "Company") in Atmos's 2007-2008 Actual Cost Adjustment (ACA) proceeding.[1] This review is brought pursuant to Sections 386.510 and 386.540 RSMo 2000.[2]

After the Western District Court issued its opinion affirming the Commission's Report and Order, OPC moved the Western District to either rehear the matter or transfer it to this Court, but the Western District Court denied both motions.

On November 14, 2012, OPC sought transfer pursuant to Rule 83.04 of the Missouri Supreme Court Rules. This Court's November 29, 2012 Order requested suggestions in opposition from Respondent. On December 10, 2012, Respondent Public Service Commission, and Intervener-Respondent Atmos Energy Corporation, filed suggestions in opposition to OPC's Application for Transfer. On January 29, 2013, this Court granted transfer.

STANDARD OF REVIEW

The standard of review applied by Courts reviewing a PSC decision is a two-pronged analysis. First, the Court must determine whether the PSC's decision was

---

[1] *See* Appendix A for a copy of the Report and Order.

[2] All statutory references are to Missouri Revised Statutes 2000.

lawful. The PSC's order was lawful if it is authorized by statute. In determining this prong of the review, the Court exercises unrestricted, independent judgment and must correct erroneous interpretations of the law. *Friendship Village of South County v. P.S.C,* 907 S.W.2d 339 (Mo. App. 1995). The second step in reviewing a PSC decision is determining whether the PSC's decision was reasonable. *Id.* This is accomplished by determining whether the order is supported by competent and substantial evidence on the whole record, and whether the decision is arbitrary, capricious, or constitutes an abuse of the PSC's discretion. *Id.* Additionally, this Court must review the Commission's decision in light of the fundamental principle that "[t]he Commission's principle purpose is to serve and protect ratepayers." *State ex. rel. Capital City Water Co. v. Public Service Commission*, 850 S.W.2d 903, 911 (Mo. App. W.D. 1993).

STATEMENT OF FACTS

In 2007 and 2008, Atmos Energy Corporation operated in Missouri as a public utility under § 386.020(43) RSMo. and as a gas corporation under § 386.020(18) RSMo.[3] Atmos operated as a local distribution company (LDC) providing retail natural gas service to approximately 65,500 residential and business customers in Missouri,[4] and was the largest natural-gas-only distributor in the United States.[5] The PSC had jurisdiction over Atmos's services, activities, and rates. § 386.250 RSMo and Chapter 393 RSMo.

[3] In 2012, Atmos sold its Missouri assets to Liberty Utilities (Case No. GM-2012-0037).

[4] Buchanan Rebuttal, Exhibit (Ex.) 2, p. 12.

[5] Sommerer Rebuttal, Ex. 27, p. 2.

Atmos is the sole owner of Atmos Energy Holdings, Inc., which is the sole owner of Atmos Energy Marketing (AEM), Atmos's gas marketing affiliate.[6]

Atmos's PSC-approved tariff included a Purchased Gas Adjustment (PGA) Clause that governed how Atmos charged its customers for the commodity cost of natural gas.[7] Atmos recovered its gas costs through its PGA rate, which Atmos was allowed to adjust up to four times during a twelve-month billing period to account for variations in Atmos's gas costs.[8] The cost of gas included the cost paid to suppliers for the purchase, transportation and storage of gas delivered to Atmos's distribution system.[9] The PGA rates Atmos charged were calculated based on Atmos's best estimate of its gas costs and volumes purchased for resale.[10]

PGA rates are designed as a straight pass-through of gas costs in that LDCs do not mark up the price of gas to their customers because LDCs are not allowed to profit from the sale of gas.[11] The PSC first authorized Missouri's LDCs to use PGA clauses during the 1960s when the sale of natural gas at the wellhead was subject to federal price control

---

[6] Sommerer Direct, Ex. 26, p. 4.

[7] *See* Appendix B for a copy of Atmos's PGA Clause: Atmos Tariff P.S.C. MO. No. 2 Sheet Nos. 40 through 42.

[8] *Id.*

[9] *Id.*

[10] Sommerer Direct, Ex. 26, p. 9.

[11] *Id.*

under the Natural Gas Act. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). Before PGA clauses, LDC gas costs were recovered through base service rates set in general rate cases that allowed for review of all expenses and revenue.[12] PGA Clauses, however, allowed LDCs to change rates for purchase of the gas commodity outside of a general rate case because the LDC, and in turn the PSC, had no control over the LDC's gas commodity costs since commodity rates were federally controlled.[13] Federal deregulation in 1985, with Federal Energy Regulatory Commission (FERC) Order 436 and in 1992 with FERC Order 636, increased the LDC's ability to control its gas commodity costs, however the PGA Clauses remained.[14]

All PGA rates are "interim and subject to adjustment" as part of Atmos's annual Actual Cost Adjustment (ACA) review.[15] The ACA review occurs at the end of a twelve-month billing period, which in this case was the period from September 1, 2007 to August 31, 2008 ("2007-2008 ACA period"), and its purpose is to adjust Atmos's rates to account for any over-recovery or under-recovery by comparing the PGA rate charged

---

[12] *State of Missouri ex rel. Midwest Gas Users' Association v. Public Service Commission*, 976 S.W.2d 470 (Mo. App. W.D. 1998).

[13] *Id.*

[14] *Id.*

[15] Atmos Tariff P.S.C. MO. No. 2 Sheet Nos. 40 through 42.

during the period to the actual incurred cost of gas.[16] The ACA period is set to capture an entire winter heating season, which typically lasts from November through March.

Atmos's service territory included portions of the northeast, southeast, and western areas of Missouri. Atmos's northeast service territory, which received gas through the Panhandle Eastern Pipeline,[17] included Atmos's Hannibal service area that served the cities of Hannibal, Canton, Palmyra and Bowling Green.[18] Atmos served approximately 14,000 customers in the Hannibal service area, of which approximately 13,000 were residential customers.[19]

The process employed by Atmos to acquire its gas supply was through a Request for Proposal (RFP) where Atmos solicited bids and selected a winning bidder from the "conforming bids."[20] After issuing RFPs for Atmos's 2007-2008 gas supply, Atmos chose to enter into two back to back supply agreements with AEM, its affiliate, for serving the Hannibal area.[21] The two Hannibal supply agreements were effective April 1, 2007 to March 31, 2008, and from April 1, 2008 to March 31, 2009.[22]

---

[16] *Id.*

[17] Buchanan Direct, Ex. 1, p. 4.

[18] *Id.*

[19] *Id*.

[20] *Id*.

[21] *Id*.

[22] Sommerer Direct, Ex. 26, p. 8.

Atmos's transactions with its unregulated affiliate AEM are governed by the PSC's Affiliate Transaction Rules, 4 CSR 240-40.015 and 40.016. The Affiliate Transaction Rules protect customers in a monopolized market by prohibiting a regulated gas corporation from providing a financial advantage to an affiliate, and include specific parameters to determine when a regulated utility has provided such an advantage to its affiliate. When acquiring natural gas from an affiliate, a regulated LDC can only compensate its affiliate at the lesser of the fair market price of the gas, or the fully distributed cost to the regulated gas company to acquire the gas for itself. 4 CSR 240-40.016(3)(A). Atmos triggered the Affiliate Transaction Rules when it used its affiliate company, AEM, to supply gas to its Hannibal service area during the winter heating season of 2007-2008.[23] The Affiliate Transaction Rules applied to Atmos because there was "a built-in conflict between Atmos' duty to maximize shareholder profits and its obligation to prudently obtain reasonably priced gas supplies for its LDC operations."[24] This inherent conflict was due to the fact that "the profits of AEM flow to its parent, Atmos, which has ultimate decision making control over its LDC's operations as well as its subordinate affiliates, including AEM."[25]

One reason for the Affiliate Transaction Rules is to prohibit the affiliate from achieving an unfair competitive advantage over non-affiliates because allowing such an

[23] Buchanan Direct, Ex. 1, p. 11.

[24] Sommerer Direct, Ex. 26, p. 4.

[25] *Id.*

advantage could erode the level of competition available for future gas purchases.[26] Atmos's witness testified that a gas marketer could gain an advantage over its competitors if it were aware of confidential facts such as the number of bidders, the names of the bidders, and "obviously their prices."[27] In adopting the Affiliate Transaction Rules, the PSC recognized that it is impossible for regulators to prevent such sharing of information between a regulated company and its affiliate.

On May 15, 2008, Atmos filed to amend the rates in its PGA tariff.[28] The PSC opened PSC Case Number GR-2008-0364 to consider the new PGA tariff and to eventually consider Atmos's 2007-2008 ACA.[29] The PSC approved the PGA rate changes proposed by Atmos during the ACA period "on an interim basis, subject to refund, pending final Commission decisions."[30]

On December 28, 2009, after a lengthy audit, the PSC Staff filed its Recommendation with the PSC regarding Atmos's 2007-2008 ACA and raised concerns

---

[26] Tr. 734.

[27] Tr. 419.

[28] Legal File (L.F.) 0001.

[29] L.F. 0025. *In the Matter of the PGA/ACA filing of Atmos Energy Corporation for the West Area (Old Butler), West Area (Old Greeley), Southeastern Area (Old SEMO), Southeastern Area (Old Neelyville), Kirksville Area, and in the Northeastern Area.*

[30] L.F. 0032.

regarding Atmos's affiliate transactions.[31] The Staff's Recommendation identified the source of its concerns as the gas supply agreements between Atmos and AEM that were in effect during the 2007-2008 ACA period, and Atmos's failure to properly document the fair market value of the transactions.[32] The PSC Staff stated that "the documentation supporting affiliate transactions needs to be clearly identified and provided to Staff to determine the true market value for those transactions."[33] In its attempt to apply the PSC's Affiliate Transaction Rules and determine the fair market price of the natural gas Atmos acquired from its affiliate, the Staff stated, "One way of assessing the fair market value of these agreements is to look at the elements of the underlying supply that was used to fulfill AEM's obligation to provide firm service."[34]

The PSC Staff sought additional information from Atmos and AEM to help determine the fair market price of the gas Atmos acquired from AEM, but Atmos claimed the documents sought by the Staff were AEM documents and that they were not in the possession of Atmos.[35] Specifically, the Staff sought contracts between AEM and its upstream gas suppliers to help determine the fair market price of the gas (i.e. the price

---

[31] L.F. 0176.

[32] *Id.*

[33] L.F. 0177.

[34] *Id.*

[35] Tr. 17.

paid between a willing buyer and an unaffiliated willing seller).[36] Atmos's response to the Staff's data request stated that the requested contracts were not Atmos documents since they were in the possession of Atmos's subordinate affiliate AEM.[37] The Staff filed a Motion to Compel, and during oral argument on the motion, Atmos argued that the contracts were irrelevant because the gas was purchased through a competitive bidding process.[38]

The PSC rejected Atmos's arguments, finding that "the existence of a bidding process does not eliminate the rule's requirement that Atmos not provide a financial advantage to its affiliate, and the mere existence of that bidding process does not necessarily establish the fair market price of the goods and services Atmos obtained from its affiliated marketing company."[39] The PSC ordered Atmos to provide the affiliate

---

[36] L.F. 0263. All parties to the case before the PSC, and the PSC itself, agreed that the "fair market value" of a good or service is defined as "the price that a seller is willing to accept and a buyer is willing to pay on the open market in an arms-length transaction." L.F. 1348, Report & Order, Case No. GR-2008-0364, November 9, 2011, p. 10 ("Order"); Tr. 627; <u>Black's Law Dictionary</u> 1549 (7th ed. 1999). Fair market value and fair market price are equivalent terms and can be used interchangeably. Tr. 118-119.

[37] L.F. 0264.

[38] Tr. 50.

[39] L.F. 0315, *Order Granting Staff's Motion to Compel Atmos to Respond to Data Requests,* July 15, 2010, p. 4.

documents and concluded that "the Commission promulgated its marketing affiliate transaction rule because dealings between a regulated utility and unregulated affiliated companies can be used to improperly push profits to the unregulated affiliate to the detriment of the captive rate payers of the utility."[40]

Atmos sought reconsideration and rehearing of the PSC's determination, arguing that the PSC lacked the authority to compel AEM to produce the requested documents.[41] The PSC responded:

> [I]f the Commission is to carry out its statutory mandate to regulate Atmos, it must, at times, have access to documents maintained by Atmos' unregulated affiliates that pertain to the operations of the regulated utility. Otherwise, a regulated utility could defeat legitimate regulation by simply shuffling key documents into the pocket of an unregulated affiliate. That is the purpose of section 4 CSR 240-40.016(7), the regulation cited in the Commission's order granting Staff's motion to compel. That regulation is consistent with the Commission's statutory authority to regulate Atmos and Atmos' argument to the contrary fails.[42]

---

[40] *Id.*, p. 5.

[41] L.F. 0322.

[42] L.F. 0327, *Order Regarding Motion For Reconsideration, Motion For Rehearing, and Request For Stay Of Order*, August 4, 2010, p. 3.

The discovery dispute between Atmos and the PSC Staff continued, forcing the PSC Staff to file a second Motion to Compel.[43] The PSC Staff sought an order compelling Atmos to provide documents related to three specific gas trades made by AEM to acquire gas for Atmos's LDC customers, and compelling Atmos to provide "AEM documents on the evaluation and tracking of the gas supply deal between AEM and Atmos."[44] The Staff stated that the information it sought was "highly relevant and necessary to its evaluation of the fair market value" of the gas supply deal between AEM and Atmos.[45] After holding an oral argument on the Motion to Compel, the PSC again directed Atmos to provide the requested information, concluding that "if Staff is to satisfy its obligation to evaluate Atmos' compliance with the affiliate transaction rule and perhaps present evidence on that question, it must be able to review and evaluate the supply contracts entered into by Atmos' affiliate. To do that it is entitled to obtain the additional information and documents it seeks."[46] The PSC also reestablished the

---

[43] L.F. 0343, *Motion to Compel Atmos' Response to Staff Data Requests 117.1 and 131.1*, September 14, 2010, p.2.

[44] *Id.*

[45] *Id.*

[46] L.F. 0817, *Order Granting Staff's Motion To Compel Atmos To Respond To Data Requests and Reestablishing Procedural Schedule*, November 10, 2010, p. 3. The PSC reached the same conclusion in its July 15, 2010 *Order Granting Staff's Motion to Compel Atmos to Respond to Data Requests*, p. 4, L.F. 0318.

suspended procedural schedule and gave the parties forty-two days to file their final round of testimony.[47]

As directed, Atmos and the PSC Staff filed their Surrebuttal Testimony on December 22, 2010. However, the Staff never received the documents from AEM that showed the price of the gas acquired by AEM to supply Atmos's customers. The PSC Staff's testimony states, "In the final analysis, the Company was unable or unwilling to produce accurate records of AEM's cost of gas related to the affiliated transaction."[48]

The PSC held an evidentiary hearing on March 23-24, 2011.[49] The PSC Staff's testimony explained that the Staff's prudency review concluded that Atmos over-recovered from customers in the Hannibal area by $308,733 for gas provided to Atmos by its affiliate AEM.[50] This proposed disallowance equals the amount of profit that AEM earned from the transaction.[51] The Staff explained that since Atmos did not document the fair market price of the gas, removing AEM's profit results in an ACA adjustment that would bring rates down to the fair market price of the gas acquired by AEM before mark-up.[52]

---

[47] *Id.*

[48] Sommerer Surrebuttal, Ex. 278, p. 1.

[49] Tr. 237-751.

[50] Tr. 641.

[51] Tr. 611-612; Sommerer Direct, Ex. 26, p. 9.

[52] *Id.*

In response to the Staff's proposed disallowance, Atmos claimed that it used a competitive bid process, and since AEM submitted the lowest bid, AEM's bids determined the fair market price of the gas purchased from AEM.[53] The PSC Staff, however, questioned Atmos's transactions and raised issue with whether the gas provided by AEM was "firm" or "interruptible" gas because each category of gas supply has a different fair market price.[54] The PSC Staff argued it is possible that AEM was able to undercut the other gas marketer bids by a substantial margin because the gas sold by AEM to Atmos was interruptible gas and not firm gas as required by the RFP.[55] The PSC Staff provided evidence showing that the agreement between Atmos and AEM was left blank where it was to indicate whether the gas was firm or interruptible, whereas other gas supply agreements between Atmos and non-affiliates specifically identified that firm gas was required.[56] The PSC Staff presented this evidence to show how Atmos could have manipulated the transaction with its affiliate to the detriment of ratepayers because

[53] Buchanan Direct Testimony, Ex. 1, p. 20.

[54] Sommerer Direct Testimony, Ex. 26, pp. 9-10.

[55] Tr. 734, Ex. 28HC, Sommerer Surrebuttal, p. 6.

[56] Ex. 12HC; Sommerer Rebuttal, Ex. 27, Schedules 5-7, 5-8, 5-9, 5-15, 5-16, 5-17, 5-18, and 5-19 are transaction confirmations between AEM and Atmos, and at the top, each confirmation fails to specify "firm" gas in the space provided for specifying "Service Level." The transaction confirmations appearing in Schedules 5-10, 5-11, 5-12, 5-13, and 5-14, however, clearly specify "firm/baseload" as the required service level.

if the other bidders were to have also bid interruptible gas, AEM may not have had the lowest bid. One of the reasons the PSC Staff sought the contracts between AEM and its supplier was to identify whether the gas AEM acquired was firm or interruptible. Atmos and AEM never produced those contracts.

Despite the PSC's earlier conclusion that the competitive bid process does not necessarily establish the fair market price of gas, and despite the PSC recognizing the need to see the documents sought by the Staff, the PSC ultimately decided in favor of Atmos in the PSC's November 9, 2011 Report and Order ("Order") and rejected the PSC Staff's proposed disallowances.[57]

In its attempt to apply its Affiliate Transaction Rules to its review of the gas supply provided by AEM, the PSC found "that Atmos' fully distributed cost of providing gas marketing services through its own employees would exceed the market price for those gas-marketing services as established by a competitive bidding process among gas marketing companies."[58] In determining that the fully distributed cost for Atmos would be greater, the PSC relied upon the testimony evidence of Atmos witness Ms. Rebecca Buchanan, where she testified that it is "unlikely" that Atmos could provide its own gas supplies at a lower cost than AEM.[59] Atmos provided no calculation or estimate as to what those costs would be, and the PSC made no specific finding on what Atmos's fully

[57] L.F. 1368, Order, p. 30.

[58] L.F. 1346, Order, p. 8.

[59] *Id*; Buchanan Direct Testimony, Ex. 1, p. 21.

distributed cost would be to purchase its own gas supply. By concluding that the fully distributed cost to Atmos would be greater than the fair market price, the PSC determined that under the Affiliate Transaction Rules the fair market price is the appropriate price for the gas supplied by AEM. The fair market price, the PSC concluded, was established by Atmos's competitive bidding process, a process the PSC previously concluded did not establish the fair market price.[60] While the Order clearly rejects the Staff's proposed disallowance, the Order does not include a finding or conclusion that the PGA rates Atmos charged in the Hannibal service area are just and reasonable.

OPC filed an Application for Rehearing and argued that the PSC's Order unlawfully misapplied the pricing standard of the Affiliate Transaction Rules, and that the PSC's Order was not based on facts that provided a sufficient basis to allow the PSC to conclude that the rates charged to Atmos's customers were just and reasonable.[61] OPC's Application for Rehearing was denied.[62] OPC appealed the PSC's Order, which was affirmed on September 18, 2012 by the Western District Court of Appeals.[63]

---

[60] L.F. 1346, Order, p. 8.

[61] Tr. 1372.

[62] L.F. 1374.

[63] State ex rel. Office of the Public Counsel v. Missouri Public Service Commission, *2012 Mo. App. LEXIS 1170*, Case Number WD74714, September 18, 2012.

POINTS RELIED ON

POINT 1

THE PUBLIC SERVICE COMMISSION ERRED IN APPROVING THE 2007-2008 ACTUAL COST ADJUSTMENT RATES FOR ATMOS ENERGY CORPORATION, BECAUSE THE ORDER IS UNLAWFUL AND UNREASONABLE AND SUBJECT TO REVIEW UNDER SECTION 386.510 RSMO, IN THAT THE ORDER VIOLATES 4 CSR 240-40.016 AND IS NOT BASED UPON COMPETENT AND SUBSTANTIAL EVIDENCE.

Authorities:

4 C.S.R. 240-40.016

§ 393.130 RSMo.

ARGUMENT

POINT 1

THE PUBLIC SERVICE COMMISSION ERRED IN APPROVING THE 2007-2008 ACTUAL COST ADJUSTMENT RATES FOR ATMOS ENERGY CORPORATION, BECAUSE THE ORDER IS UNLAWFUL AND UNREASONABLE AND SUBJECT TO REVIEW UNDER SECTION 386.510 RSMO, IN THAT THE ORDER VIOLATES 4 CSR 240-40.016 AND IS NOT BASED UPON COMPETENT AND SUBSTANTIAL EVIDENCE.

The PSC's November 9, 2011 Report and Order is unlawful because the PSC did not comply with the PSC's Affiliate Transaction Rules, 4 CSR 240-40.016, in that the PSC did not ensure that Atmos charged customers the lesser of the fair market price or the fully distributed cost for the gas supply acquired from Atmos's affiliate, AEM. Furthermore, the Order is unreasonable because the finding that Atmos acquired gas supply from AEM at the lesser of fully distributed cost or fair market price is not based on competent and substantial evidence.

<u>The Report and Order is Unlawful</u>

The Affiliate Transaction Rules specifically prohibit a regulated gas corporation from providing a financial advantage to an affiliate. It states:

> (A) A regulated gas corporation shall not provide a financial advantage to an affiliated entity. For the purpose of this rule, a regulated gas corporation shall be deemed to provide a financial advantage to an affiliated entity if –

1. It compensates an affiliated entity for information, assets, goods or services above the lesser of –

A. The fair market price; or

B. The fully distributed cost to the regulated gas corporation to provide the information, assets, goods or services for itself.

4 CSR 240-40.016(3)(A). This consumer protection has been labeled the "asymmetrical pricing" provision of the Affiliate Transaction Rules. The Affiliate Transaction Rules also include evidentiary standards to be followed by an LDC when it engages in an affiliate transaction to ensure compliance with the asymmetrical pricing standard:

> (B) In transactions that involve either the purchase or receipt of information, assets, goods or services by a regulated gas corporation from an affiliated entity, the regulated gas corporation shall document both the fair market price of such information, assets, goods and services and the fully distributed cost to the regulated gas corporation to produce the information, assets, goods or services for itself.

4 CSR 240-40.016(4)(B). The Affiliate Transaction Rules also include recordkeeping requirements mandating that LDCs maintain records documenting affiliate transactions:

> (C) In addition each regulated gas corporation shall maintain the following information regarding affiliate transactions on a calendar year basis:
>
> 1. Records identifying the basis used (e.g., fair market price, fully distributed costs, etc.) to record all affiliate transactions; and

2. Books of accounts and supporting records in sufficient detail to permit verification of compliance with this rule.

4 CSR 240-40.016(5)(C). The rules also extend the recordkeeping requirements under the rule to the LDC's unregulated affiliates. 4 CSR 240-40.016(6).

The PSC's Order of Rulemaking that promulgated the Affiliate Transaction Rules explained the PSC's rationale for establishing the asymmetrical pricing requirement as a necessary method of protecting monopoly service customers:

> FDC [fully distributed cost] assures that all costs are accounted and recovered and FMP [fair market price], in conjunction with FDC, assures that the regulated utilities obtain the best prices or lowest costs possible whether buying or selling or producing goods or services. Asymmetrical pricing assures that the pricing standard is always applied to the favor of regulated utility's customers.[64]

When the PSC adopted the Affiliate Transaction Rule, Atmos and several other LDCs appealed and sought reversal of the PSC's Order of Rulemaking. Atmos and the other LDCs argued that the PSC acted outside its authority by imposing recordkeeping requirements on both the LDC and its unregulated affiliate. The Supreme Court of Missouri upheld the rules and cited to the PSC's brief when it stated:

> …the rules are a reaction to the emergence of a profit-producing scheme among public utilities termed "cross-subsidization," in which utilities abandon

---

[64] *Missouri Register*, Volume 25, No. 1, p. 63, January 3, 2000, *See* Appendix C.

> their traditional monopoly structure and expand into non-regulated areas. This expansion gives utilities the opportunity and incentive to shift their non-regulated costs to their regulated operations with the effect of unnecessarily increasing the rates charged to the utilities' customers. *See United States v. Western Elec. Co., 592 F. Supp. 846, 853 (D.D.C. 1984)* ("As long as a [public utility] is engaged in both monopoly and competitive activities, it will have the incentive as well as the ability to 'milk' the rate-of-return regulated monopoly affiliate to subsidize its competitive ventures.") To counter this trend, the new rules – and in particular, the asymmetrical pricing standards – prohibit utilities from providing an advantage to their affiliates to the determent of rate-paying customers. In addition, to police compliance, the rules require the utilities to ensure that they and their affiliates maintain records of certain transactions.

State ex rel. Atmos Energy Corp. v. P.S.C., 103 S.W.3d 753, 763 (Mo. 2003).

There is no question that Atmos engaged in affiliate transactions with its affiliate AEM. The issue of this appeal is whether the PSC's Order enforced the necessary asymmetrical pricing provision and the recordkeeping requirements of the rules regarding the gas supply Atmos acquired from AEM for the Hannibal area. When Atmos engages in affiliate transactions, it is required to document both the fair market price and the fully distributed cost of the transaction. 4 CSR 240-40.016(4)(B). These documents are to provide the "evidentiary standards" for determining whether Atmos complied with the asymmetrical pricing standard. 4 CSR 240-40.016(4)(B).

Atmos did not document the fair market price of the gas it acquired from AEM, and instead argued that the price Atmos paid to its affiliate *was* the fair market price. The PSC agreed with Atmos in its Order, and in doing so, the PSC erred because the transactions between Atmos and AEM were not conducted at arm's-length and cannot be used to determine the fair market price. The PSC's Order defined the fair market price as "the price that a seller is willing to accept and a buyer is willing to pay on the open market in an arms-length transaction."[65] Arm's length transactions are defined as "dealings between two parties who are not related or not on close terms and who are presumed to have equal bargaining power."[66] By definition, a transaction between Atmos and AEM cannot determine the fair market price because of the close affiliated relationship between the two entities. The PSC's Order is an unlawful interpretation of the Affiliate Transaction Rules. By unlawfully concluding that an affiliate transaction can establish the fair market price, the PSC's Order is detrimental to the consumers that the rule is meant to protect.

The non-winning bids received by Atmos cannot provide the missing fair market price determination because those bids have not been reviewed or verified as reflective of the market price a willing buyer and willing seller would agree upon. Therefore, Atmos must demonstrate another basis for determining the fair market price of the gas it acquired from AEM. One way to accomplish this, as the Staff attempted to do before

---

[65] L.F. 1348; Tr. 627; Black's Law Dictionary 1549 (7th ed. 1999).

[66] Black's Law Dictionary 103, (7th ed. 1999).

Atmos and AEM refused to provide the necessary documents, is to determine Atmos's fair market price based upon AEM's cost since AEM's purchase of gas was an arm's-length transaction between a willing buyer and a willing seller in a competitive market.

In addition, Atmos failed to follow the Affiliate Transaction Rules when it did not determine its fully distributed cost to supply the gas for itself. The rule defines "fully distributed cost" as follows:

> (F) Fully distributed cost (FDC) means a methodology that examines all cost of an enterprise in relation to all the goods and services that are produced. FDC requires recognition of all costs incurred directly or indirectly used to produce a good or service. Costs are assigned either through a direct or allocated approach. Costs that cannot be directly assigned or indirectly allocated (e.g., general and administrative) must also be included in the FDC calculation through a general allocation.

4 CSR 240-40.016(1)(F). This definition requires a detailed cost determination that Atmos did not perform. Atmos only provided general statements and opinions to the effect that it is "unlikely" that it could achieve the same results for less than what it paid AEM.[67] Atmos's vague assertions and assumptions regarding its fully distributed cost do not satisfy the evidentiary standards of the Affiliate Transaction Rules, which specifically require documentation of both the fair market price and fully distributed cost. 4 CSR 240-40.016(4)(B). Claiming one calculation is less than the other, without performing

[67] Buchanan Direct, Ex. 1, p. 21.

and documenting the calculation, is insufficient to satisfy the requirement of the rule. The rule anticipates that the utility will do a cost calculation to accurately determine which of the two is less - fully distributed cost or fair market price. This determination is to be based upon "books of accounts and supporting records in sufficient detail to permit verification of compliance with [the] rule." 4 CSR 240-40.016(5)(C). Atmos performed no such cost calculation, and the PSC unlawfully determined that Atmos's fully distributed cost was greater than the fair market price and unlawfully concluded that Atmos's evidentiary standard was satisfied.

Atmos argued that it "does not have personnel experienced in obtaining gas supplies," but Atmos does not explain why it could not hire or contract for such personnel, or the cost to do so.[68] If Atmos's subordinate affiliate is capable of hiring personnel to perform these functions, there is nothing to suggest Atmos, the largest natural-gas distributor in the United States,[69] could not do the same. The evidence in the case suggests that Atmos is more than capable of providing this service in-house, and that smaller LDCs in Missouri perform this function for themselves.[70]

Atmos argued that to provide the gas supply functions in-house, it "would need to hire or train additional personnel at a substantial cost and develop processes already utilized by gas marketers," but provided no quantitative evidence of the cost of these

---

[68] *Id.*, pp. 20-21.

[69] Sommerer Rebuttal, Ex. 27, p.2.

[70] Sommerer Surrebuttal, Ex. 28, p. 5.

activities.[71] Simply stating that the costs would be "substantial" does not satisfy the requirement that a fully distributed costs determination "requires recognition of all costs incurred directly or indirectly used to produce a good or service." 4 CSR 240-40.016(1)(F). Atmos's witness testified, "It is unlikely that Atmos could perform such specialized services for the sole benefit of the Missouri jurisdiction at a lower cost than a marketer who performs these services routinely for a much broader customer base."[72] Concluding that it is simply "unlikely" suggests that it is possible that Atmos *could* perform the same functions for less than its affiliate.

The PSC Staff attempted to determine the fully distributed cost for Atmos to acquire the gas supply for itself, and requested data showing AEM's overhead costs to help determine what Atmos's overhead costs would be if Atmos were to acquire the gas supply for itself.[73] Atmos and AEM refused to provide this data.[74]

The Supreme Court of Missouri recognized that Atmos has an incentive to "milk" its customers to benefit its affiliate because the affiliate's profits flow back to Atmos.[75] Purchasing gas from an affiliate creates an opportunity for Atmos to capitalize on this

---

[71] Buchanan Direct, Ex. 1, p. 21.

[72] *Id.*

[73] Sommerer Rebuttal, Ex. 27, pp. 5-7.

[74] *Id.*

[75] *State ex rel. Atmos Energy Corp. v. P.S.C.*, 103 S.W.3d 753, 763 (Mo. 2003).

incentive.[76] The Affiliate Transaction Rules protect consumers from such collusion by putting in place price restrictions that must be supported by documented costs. If these rules are not followed, the consumer protections disappear.

An example of the advantages that an affiliate can garner through an affiliate transaction was a focus of the PSC Staff's case, and involved the supply agreement between Atmos and AEM. Staff presented evidence suggesting that under the Atmos/AEM contract, AEM was allowed to supply Atmos with "interruptible" gas supplies, which are a less reliable supply source than "firm" or guaranteed gas supplies.[77] Allowing AEM to use interruptible gas to fill firm supply contracts creates greater profit potential for AEM because a lower reliability guarantee comes with a lower cost to AEM.[78] The Staff discovered that the firm gas requirement from the RFP did not appear

[76] In fact, Atmos and AEM have shown a willingness to capitalize on such incentives. During the same time frame as the 2007-2008 ACA, Atmos and AEM unlawfully violated Federal Energy Regulatory Commission's (FERC) regulations pertaining to the competitive bidding of natural gas. Following a FERC investigation, Atmos and AEM were ordered to pay a civil penalty of $6,364,029 and disgorged $5,635,971 in unjust profits. *In re Atmos Energy Corporation, Atmos Energy Marketing, Inc., Trans Louisiana Gas Pipeline, Inc.,* FERC Docket No. IN12-1-000, Order Approving Stipulation and Consent Agreement, 17 FERC ¶ 61,190, Issued December 9, 2011.

[77] Tr. 721-722; Sommerer Rebuttal, Ex. 27, pp. 5-7.

[78] *Id.*

in the documentation confirming certain transactions between Atmos and AEM, while other confirmations maintained the firm requirement.[79] Allowing an affiliate to fulfill an RFP for firm gas with interruptible gas could undercut the competitive gas supply process if the affiliate is allowed greater risks than an unaffiliated supplier.[80]

The PSC's standard for the recoverability of Atmos's gas supply costs arises from the statutory mandate that all charges made by a gas company must be just and reasonable. § 393.130.1 RSMo; *State ex rel. Associated Natural Gas Co. v. P.S.C.*, 954 S.W.2d 520, 530 (Mo. App. W.D. 1997). The role of the Court when reviewing a PSC decision is to determine whether the PSC decision was lawful and reasonable. *City of Oak Grove v. Public Service Commission*, 769 S.W.2d 139, 141 (Mo. App. W.D. 1989). In determining whether the PSC's decision was lawful, the Court exercises unrestricted, independent judgment and must correct erroneous interpretations of the law. *Friendship Village v. Public Service Commission*, 907 S.W.2d 339, 344 (Mo. App. W.D. 1995).

---

[79] Sommerer Rebuttal, Ex. 27, Schedules 5-7, 5-8, 5-9, 5-15, 5-16, 5-17, 5-18, and 5-19 are transaction confirmations between AEM and Atmos, and at the top, each confirmation fails to specify "firm" gas in the space provided for specifying "Service Level." The transaction confirmations appearing in Schedules 5-10, 5-11, 5-12, 5-13, and 5-14, however, clearly specify "firm/baseload" as the required service level.

[80] Tr. 734.

The Report and Order is Unreasonable

If the Court determines that the PSC's order was lawful, the reasonableness of the PSC's Order is next considered. *Inter-City Beverage Co.*, 972 S.W.2d 397 (Mo. App. W.D. 1998). "An order's reasonableness depends on whether it is supported by substantial and competent evidence on the whole record; whether it is arbitrary, capricious, or unreasonable; or whether the Commission abused its discretion." *State ex rel. Alma Telephone Co. v. P.S.C.*, 40 S.W.3d 381 (Mo. App. W.D. 2001).

OPC also seeks reversal of the PSC's Order because it is unreasonable in that the PSC's determination that Atmos charged the lesser of fair market price or fully distributed cost was not based on competent and substantial evidence. Atmos performed no cost calculation and instead offered opinion evidence that spoke in general terms, and even then, left open the possibility that the fully distributed cost could be less when Atmos claimed that this possibility is only "unlikely." Atmos was required to do more to determine fully distributed cost. Because Atmos did not do more, the evidentiary record relied upon by the PSC is insufficient to support the PSC's conclusion that Atmos charged a lawful rate to its affiliate. For judicial review to have any bearing, there is a minimum requirement that the evidence make sense to the reviewing court – the Court may not approve an orders imply on the faith of the PSC's expertise. *State ex rel. GTE North, Inc. v. P.S.C.*, 835 S.W.2d 356 (Mo. App. W.D. 1992).

The Staff's audit determined that Atmos did not retain records to allow the Staff to determine the fair market value of the gas Atmos acquired from its affiliated AEM. The Affiliate Transaction Rule's "evidentiary standards", however, require Atmos to "document" the fair market price of the natural gas purchased from AEM, and to document the fully distributed cost for Atmos to acquire the gas itself. 4 CSR 240-40.016(4). Furthermore, the rules' evidentiary standard requires that Atmos "must demonstrate" that it: 1) considered all gas costs, 2) calculated the gas costs at times relevant to the transaction, 3) allocated joint and common gas costs appropriately, and 4) adequately determined the fair market price of the gas. 4 CSR 240-40.016(4)(C). The rules also contain recordkeeping requirements, and specifically require Atmos to "maintain the following information regarding affiliate transactions":

> 1. Records identifying the basis used (e.g. fair market price, fully distributed cost, etc.) to record all affiliate transactions; and
> 2. Books of accounts and supporting records in sufficient detail to permit verification of compliance with this rule.

4 CSR 240-40.016(5)(C).

Unless the consumer protections provided by the rule are followed, consumers have no assurances that the affiliate is not being subsidized by the regulated utility's customers. "However difficult may be the ascertainment of relevant and material factors in the establishment of just and reasonable rates, neither impulse or expediency can be substituted for the requirement that rates be "authorized by law" and "supported by competent and substantial evidence upon the whole record." *Article V, § 22, Constitution of Missouri*." *State ex rel. Sprint Spectrum L.P. v. P.S.C.*, 112 S.W.3d 20 (Mo. App. W.D. 2003). When an agency's order indicates that the agency completely failed to consider an important aspect or factor of the issue before it, the Court may find that the agency acted arbitrarily and capriciously. *State ex rel. GS Techs. Operating Co. v. P.S.C.*, 116 S.W.3d 680, 692 (Mo. App. W.D. 2003).

In *Midwest Gas Users' Association v. P.S.C.*, 976 S.W.2d 470, 483 (Mo. App. 1998), the Missouri Court of Appeals held that § 393.270.4 RSMo requires Commission rate determinations to be based on all relevant factors. Factors that are relevant to gas supply transactions between affiliates are those facts demonstrating whether Atmos properly charged AEM the lesser of fair market price or fully distributed cost. The PSC's Order did not consider these relevant factors, and is therefore not based on the evidence needed to determine whether 4 CSR 240-40.016 was followed. By not basing its decision on competent and substantial evidence, the PSC's decision is arbitrary, capricious, and constitutes and abuse of the PSC's discretion.

a. Presumption of Prudence

While the PSC's willingness to accept Atmos's unsubstantiated claims is one reason why the PSC's decision is not based on competent and substantial evidence, the process employed by past PSC decisions, and followed by the PSC in its Order, is equally responsible for the Order's unreasonableness. Although the PSC has not adopted a PGA rule, the PSC's practice is to employ a prudence standard, whereby the PSC presumes that all gas costs incurred by the LDC were prudent.[81] This presumption of prudence was established during a time when federal regulations set wellhead prices, and the PSC had little choice but to presume that an LDC's costs were prudent since the LDC had no

[81] Order, p.20.

choice but to pay the federal wellhead price. Despite the greater control that today's LDC's have over their gas costs, the PSC continues to presume that all LDC gas costs are prudently incurred. The PSC puts the burden on the PSC Staff and OPC to raise "serious doubt" about whether the gas costs were incurred prudently.[82]

At the time the prudency standard was first adopted, the presumption made sense because of the utility company's lack of control over gas prices. Today, however, federal deregulation has created a significantly different regulatory environment, and LDCs today have much greater control over gas prices, which can be manipulated to create a financial advantage for the affiliate.[83] No Missouri court has specifically addressed whether the prudency presumption is appropriate for affiliate transactions, and the Western District Court of Appeals Opinion in this case relies heavily upon that presumption in affirming the PSC's Report and Order.

It is not OPC's contention that the Affiliate Transaction Rules modified the burden of proof. In fact, the rule states specifically that it does not modify the burden of proof. Instead, OPC's argument is that the presumption of prudence should not have applied to affiliate transactions before the Affiliate Transaction Rules were adopted, just as the presumption should not apply today, due to the likelihood of collusion, and the difficulty, if not impossibility, of proving such collusion.

---

[82] *Id.*

[83] Tr. 419.

There are no Missouri cases directly on point to provide an analysis of whether the presumption of prudence should apply to affiliate transactions. The Court is aided, however by relevant decisions from other jurisdictions concluding that affiliate transactions do not carry a presumption of reasonableness. In *U.S. West Communications, Inc. v. Utah Public Serv. Comm'n*, 901 P.2d 270, 1995 Utah LEXIS 46 (Utah, 1995), the Supreme Court of Utah concluded:

> Whatever merit USWC's argument might have in the context of non-affiliate expenses, we do not think an affiliate expense should carry a presumption of reasonableness. While the pressures of a competitive market might allow us to assume, in the absence of a showing to the contrary, that non affiliate expenses are reasonable, the same cannot be said of affiliate expenses not incurred in an arm's length transaction.

In *Boise Water Corporation v. Idaho Public Utilities Commission,* 555 P.2d 163 (Idaho 1976), the Supreme Court of Idaho reached a similar conclusion:

> The reason for this distinction between affiliate and non-affiliate expenditures appears to be that the probability of unwarranted expenditures corresponds to the probability of collusion. In dealing with *non-affiliates* the pressures of a competitive market and the fact of arm's length bargaining for goods and services allows us to assume, in the absence of a showing to the contrary, that such operating expenditures are legitimate.

In *The Washington Water Power Company v. Idaho Public Utilities Commission,* 101 Idaho 567, 617 P.2d 1242 (Idaho 1980), the Idaho Supreme Court analyzed cases from other states and determined that the majority of states follow a traditional approach that does not presume affiliate transactions to be prudent:

> Under the traditional approach, it is unquestioned that the utility has the initial burden of showing prima facie the reasonableness of its operating expenses. *Boise Water Corp. v. Idaho Public Utilities Commission, 97 Idaho 832, 555 P.2d 163 (1976).* In the case of payments to an affiliate, moreover, unlike in the case of payments to a non-affiliate, a mere showing of actual incurrence of the expense does not establish a prima facie case of reasonableness.

There should be no presumption of reasonableness for transactions that are not conducted at arm's length. To do otherwise violates the Section 393.130.1 RSMo requirement that all charges must be just and reasonable.

Conclusion

The court should reverse the Commission's order because it is unlawful, unreasonable, arbitrary and capricious and an abuse of discretion.

Respectfully submitted,

OFFICE OF THE PUBLIC COUNSEL

___/s/ ***Marc D. Poston***___
Marc Poston (# 45722)
Deputy Public Counsel
Missouri Office of the Public Counsel
P. O. Box 2230
Jefferson City, MO 65102
(573) 751-5558 (Telephone)
(573) 751-5562 (Fax)
e-mail: marc.poston@ded.mo.gov

Certificate of Service

I hereby certify that this brief and accompanying appendix was filed through the Court's electronic filing system, and notice of this filing, along with an electronic copy of this filing, was provided to the following counsel this 8th day of March 2013.

Jennifer L. Heintz
P.O. Box 360
Jefferson City, MO 65102
Fax: (573) 522-4016
Attorney for the Missouri Public Service Commission

Larry W. Dority
101 Madison St.
Suite 400
Jefferson City, MO 65102
Fax: (573) 636-0383
Attorney for Atmos Energy Corporation

___/s/ ***Marc D. Poston***___
Marc D. Poston

CERTIFICATE PURSUANT TO RULE 84.06(c) AND 84.06(g)

I hereby certify that the foregoing Brief of Appellant Office of the Public Counsel of Missouri complies with the limitations contained in Rule 84.06(b) and, according to the word count of the word-processing system used to prepare the Brief (excepting there from the cover, certificate of service, this certificate, and the signature block and the appendix), contains 8,518 words.

/s/ *Marc D. Poston*

Marc Poston (# 45722)
Deputy Public Counsel
Missouri Office of the Public Counsel
P. O. Box 2230
Jefferson City, MO 65102
(573) 751-5558 (Telephone)
(573) 751-5562 (Fax)
e-mail: marc.poston@ded.mo.gov
Attorney for Appellant